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Inflation Targeting in Africa

Stephen A. O'Connell

1. Introduction

In an inflation targeting (IT) framework, the central bank commits to a publicly announced numerical range for inflation, subordinates other intermediate targets, and institutionalizes its commitment through a set of mechanisms that emphasize transparency and accountability for outcomes. Between 1989 and 2008, the number of central banks practising full-fledged IT (FFIT) rose from zero to 27.¹ South Africa became SSA's first adopter in 2000, and in 2007 Ghana was the first low-income country in the world to adopt the framework. Many other countries adopted elements of IT while retaining a policy role for exchange rate or monetary targets; in SSA this list includes the region's two highest-performing economies, Botswana and Mauritius.

Ghana's decision was consistent with a global pattern that has encouraged adoption of FFIT at lower and lower levels of development. Durability has undoubtedly contributed: as of 2009 no country had abandoned IT, despite the fact that very few adopters satisfied all the preconditions emphasized in the early literature. But empirical studies also give the framework high marks. On balance, the evidence suggests that inflation targeters achieve more stable and somewhat lower inflation rates than non-targeters, with little or no sacrifice in terms of employment and output; and that external shocks are somewhat less likely to destabilize expectations (Mishkin and Schmidt-Hebbel 2007). The policy literature has accommodated this ever more impressive track record by gradually softening its concern for preconditions.²

In this chapter I review the logic of IT and examine its relevance for SSA. Issues like fiscal dominance, supply shocks, and institutional development loom large in SSA, relative to the constraints imposed—at least for now—by high capital mobility. Moreover Africa's central banks have already substantially increased the attention given to inflation in the conduct of monetary policy, and with considerable success. The appeal of FFIT may—ironically—be strongest in the CFA zone, where it would replace the most successful inflation anchor the continent has ever known.

¹ I use the IMF's online listing of *de facto* monetary policy anchors in April 2008. The total is 28 if the European Central Bank (which has officially resisted being characterized as an inflation targeter) is included.

² Freedman, Laxton, and Otker-Robe (forthcoming) review IT in theory and practice.

2. The global emergence of inflation targeting

The Great Inflation in the USA³—with its global impact and long aftermath among the emerging-market economies—created a revolution in the design and conduct of monetary policy. By the late 1990s, economists and central bankers worldwide were in agreement that good policy consisted in the exercise of ‘constrained discretion’ (Bernanke and Mishkin 1997). The intellectual underpinnings of this consensus are well covered elsewhere (Woodford 2003). In practical terms, the Volcker disinflation of 1979–84 was a watershed. Technically the Fed did not become an inflation targeter in 1979. But the Fed publicly took on the inflation rate as the unambiguous responsibility of monetary policy; it placed disinflation above other objectives; and it disinfated without regard to the exchange rate. These themes were taken up worldwide over the following two decades.

Attitudes towards the exchange rate evolved gradually, but by the late 1980s financial liberalization among the industrial countries had unleashed short-term capital movements on a global basis. Facing ever sharper dangers of speculative attacks and wishing to liberalize their own financial controls, central banks began to move away from fixed-but-adjustable pegs. Some adopted harder pegs, but the majority retained an active role for monetary policy by choosing greater exchange rate flexibility.

FFIT therefore emerged in a context of global disinflation and amid a shift away from exchange rate anchors. As nominal anchors, money growth targets were the obvious alternative and were widely employed starting in the 1970s. But they were less transparent than exchange rates, and outside SSA they became associated with policy instability under conditions of financial innovation. All anchors, moreover, were subject to credibility problems. In 1989, the Government of New Zealand cut through these concerns institutionally. Under the Reserve Bank of New Zealand Act, the central bank would be legally bound to achieving a tight numerical range for inflation.⁴

The spread of FFIT after 1990 was influenced both by the success of adopters and by a further development within academe. Taylor (1993) observed that Fed policy after 1980 was well approximated by a reaction function relating the policy interest rate to the deviations of inflation from a target and output from its natural rate. The Taylor rule gave operational content to constrained discretion, by reconciling a counter-cyclical role for policy (discretion) with an aggressive response to inflation (constraint). By the late 1990s it was clear that in models with forward-looking expectations and price rigidities, Taylor-type rules not only anchored expectations but also generated highly favourable combinations of volatility in inflation and output. The rule-based approach to

³ Roughly 1965–84; see Meltzer (2005).

⁴ Subsequent FFIT systems have been less draconian, but all constrain central banks to pursue numerical targets for inflation.

monetary policy evaluation bore more directly on constrained discretion than on FFIT *per se*, but acquired an important role in the internal discourse of inflation-targeting central banks (Berg, Karam, and Laxton 2006).

3. The African context

FFIT combines a novel choice of nominal anchor with a set of institutional commitments designed to enhance the credibility and predictability of policy. How relevant are these innovations for African countries?

The first of two dominant themes in Africa's inflation history is the effectiveness of monetary unions at maintaining hard exchange rate pegs and thereby anchoring the inflation rates of member countries to those of the pivot currency (Masson and Pattillo 2005). The institutions of the CFA zone overcame fiscal dominance—a situation in which public sector solvency has to be maintained through monetary finance, rather than through adjustments in spending or taxes—by locating monetary policy at the supranational level, where no single member government could dictate its terms. In the institutional dimension, therefore, it is not clear that FFIT offers important advantages for the fourteen CFA countries: the arrangements of the zone have been credible and predictable.⁵ A hard peg, however, leaves very little room for discretion. If capital mobility is high, it effectively gives up monetary policy altogether. This rigidity produced a long and costly economic contraction in the zone when adverse shocks called for a real depreciation in the 1980s and early 1990s and the relative price adjustment had to be accomplished through deflation. A switch to inflation targeting, by allowing zone-wide exchange rate flexibility, might produce a superior balance of constraint and discretion.

There is also a deeper institutional question about the appropriate locus of accountability. The convertibility guarantee from France and the EU underpins the viability of the peg. While this form of dependence is almost certainly desirable relative to a unilateral zone-wide peg, it may have long-run costs in terms of institutional development, relative to a regime that can be managed autonomously by its own members.

The second dominant theme is that most of Africa did experience—and defeat—a 'great inflation' of its own. The phenomenon was restricted to the continent's national currencies, including the South African rand.⁶ In contrast to the supranational institutions of the CFA zone, national central banks lacked the legal or *de facto* autonomy to resist fiscal pressures. By the early 1980s exchange rate anchors had been discredited—

⁵ Mali (rejoining in 1984), Equatorial Guinea (1985), and Guinea Bissau (1997) were willing to give up their own currencies to join the zone.

⁶ The rand is the pivot of the Common Monetary Area, but Lesotho, Namibia, and Swaziland have no influence over South Africa's monetary policy.

and marginalized—through a proliferation of distorting exchange controls and black markets. The structural adjustment era swept away these controls, so that by the early 1990s central banks were committed to fostering macroeconomic stability indirectly, through market-determined prices for foreign exchange and credit. Disinflation was by no means immediate; letting exchange rates go unleashed inflation, particularly where market-based reforms were undertaken before establishing fiscal discipline. The number of countries with annual inflation above 40% peaked at eleven in 1995. But by the late 1990s, central banks across the continent had successfully employed money-based disinflation programmes to bring inflation down into single or low double digits.

Tight fiscal rules (e.g. cash budgets) played a key role in overcoming fiscal dominance during the 1990s. The majority of non-CFA central banks now operate reserve-money frameworks that are the direct descendants of IMF conditionality programmes and retain severe limits on central bank finance to government. These frameworks target inflation in the well-defined sense that benchmarks for reserve-money growth are derived from projections of inflation-consistent growth in money demand; in most cases the central bank announces a desired range for inflation. Many countries now also boast new legislative charters that clarify the central bank's mandate and shelter it from short-term political pressures.

4. Why add binding numerical targets?

Existing frameworks have performed well over the past decade, and have incorporated many of the features of FFIT without committing to numerical targets. Outside the CFA zone, most central banks are practising versions of what Stone (2003) calls 'inflation targeting lite' (ITL), focusing seriously on inflation but also giving systematic attention to exchange rate targets.⁷ Why go further? I offer observations rather than answers.

First, FFIT may ironically make more sense for African monetary unions than for national currencies. For the CFA zone, FFIT combines a better choice of nominal anchor with a transition path away from dependence on the exchange rate guarantee. A similar argument holds for planned monetary unions elsewhere in Africa, where exchange rate guarantees are not in prospect and the political instability of the major players—Nigeria in West Africa and Kenya in East Africa—strengthens the case for union-wide restraints.

Second, FFIT may—ironically again—be a more constructive choice for African countries still struggling with fiscal dominance than it is for those who have overcome it by other means. In contrast to the industrial-country situation, there is no empirical

⁷ On the prevalence of exchange rate objectives in SSA, see IMF (2008: Table 2.1).

consensus in favour of very low inflation in low-income countries.⁸ This gives the welfare logic of FFIT a distinctly second-best flavour in SSA: if credibility can be obtained through other means, keeping inflation low and stable may not be the best way to use it. However, where existing frameworks cannot be relied on to keep expected inflation below (say) 15%, FFIT has a reasonable chance of targeting the policy distortion at its source. The framework requires an explicit endorsement from the government, and it directly educates the public that monetary policy cannot create high public-sector wages, a competitive real exchange rate, or even cheap credit on a sustainable basis. This may be the right path to credibility when external props are absent. South Africa provides an example: without FFIT the Reserve Bank would undoubtedly be under even greater pressure than it already is, following the populist transition within the ANC, to accommodate the food and fuel price shocks of 2007–8.⁹

Third, since FFIT was never designed for low-income countries, their economic structure raises unresolved questions. Does it make sense to target inflation when exchange rates, food prices, and public-sector prices (utilities, fuel, and public-sector wages) are more prominent—and verifiable—in the public eye? Can the framework be deployed successfully when supply shocks are dominant and the GDP gap is difficult to measure? Is there a role for exchange rate targets, given imperfect capital mobility and the importance of export promotion? What operational policy rules can be used when there is not a strong transmission from policy interest rates to aggregate demand, and where (as in almost all African cases) central banks use balance sheet instruments rather than interest rates? Ghana faces all of these questions (Sowa and Abradu-Otoo 2009). As of late 2009 the Bank of Ghana had yet to achieve a target range that was already higher and wider than that of any other targeter. Its struggles with transparency are palpable; in some quarters the Bank describes itself as practising ITL rather than FFIT (IMF 2008: 5). It remains to be seen whether the distortions implied by committing to a target that is rarely met, of unclear salience, and difficult to forecast are fundamentally damaging to economic stability—or are more than compensated by committing the fiscal authorities to self-restraint and forcing the pace of institutional maturation within the central bank.

Finally, recent events are testing inflation targeting in new ways. A confluence of food and fuel price shocks in 2007 and 2008 pushed virtually all targeters above their ranges in 2008—the first time a miss of this scope had occurred. The global financial crisis sharply reversed this impetus, confronting industrial-country targeters with risks of deflation, and generating massive rescue operations with uncertain implications for future price stability. These developments have dampened the short-run enthusiasm for FFIT in

⁸ Modest inflation allows large relative price changes to occur without outright deflation. The CFA experience of 1980–94 suggests, surprisingly, that deflation is damaging to growth even in low-income economies with small formal sectors.

⁹ Frankel, Smit, and Sturzenegger (2007) discuss macroeconomic management in South Africa.

Africa—fortuitously in my view, given the viability of existing ITL systems and the scope for further improvements—while generating sharp reminders of the necessary regulatory complements to any successful monetary policy framework.

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